ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	De Leon, et al.	Analyst:	David Scott	Bill Number:	SB 116
Related Bills:	See Legislative History	Telephone:	845-5806	Amended Date:	July 7, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Employer Hiring Credit/Business Income Apportionment/Mandatory Single Sales Factor & Add Elective Four Factor Formula/K-12 Investment Tax Credit Program Special Fund or Higher Education Investment Tax Credit Program Special Fund Contributions Credit

SUMMARY

Provisions of this bill would make the following changes:

Provision No. 1: Expand the current Jobs Tax Credit to taxpayers that employ 50 or fewer employees, increase the credit amount to $4,000 per new hire, and change the cut-off date to the earlier of the end of the quarter that the $400 million cap is reached or December 31, 2012.

Provision No. 2:

- Repeal the annual election to use single sales factor;
- Require taxpayers not in a qualified business activity or that make an election to use the four-factor formula to use a mandatory single sales factor;
- Require all taxpayers to use the “market rule” for assigning sales to the sales factor; and
- Allow qualified taxpayers to assign 50 percent of the mandatory sales factor to California.

Provision No. 3: Allow taxpayers a tax credit equal to 75 percent of their cash contributions made to either of two new special education funds with an aggregate credit cap of one billion dollars ($1,000,000,000) per calendar year.

The bill also makes non-substantive technical changes to the Revenue and Taxation Code (R&TC).

This analysis will not address the bill’s provision for sales and use tax exemption for certain qualified tangible personal property as it does not impact the department or state income tax revenue.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Board Position:			Executive Officer	Date
_______ S	_______ NA	___X___ NP		
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Summary of Amendments

The July 7, 2011, amendments, add provisions one (expand new jobs credit) and three (education contribution credit), amended provision two (mandatory single sales factor), summarized above, and made non-substantive technical changes.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would go into immediate effect. Provisions one (expand new jobs credit) and two (mandatory single sales factor) would be specifically operative for taxable years beginning on or after January 1, 2011, and provision three (education contribution credit) would be specifically operative for taxable years beginning on or after January 1, 2012.

PROVISION NO. 1 EXPAND JOBS CREDIT

Sections 17053.8 and 23623

PURPOSE OF THE PROVISION

According to the author's office, this provision seeks to facilitate job creation and assist in California's economic recovery by expanding eligibility for the existing Jobs Credit.

ANALYSIS

FEDERAL/STATE LAW

Current state law, SBX 3 15 (Calderon, Stats. 2009, Third Extraordinary Session, Ch. 17) allows a credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time basis equivalent. The calculation of annual full-time basis would be: (1) for full-time employees paid on an hourly basis - the total number of hours worked for the taxpayer by the employee (not to exceed 2,000 hours per employee) divided by 2,000, or (2) for salaried full-time employees – the total n umber of weeks worked for the taxpayer by the employee divided by 52. This credit is allocated by the Franchise Tax Board (FTB) and has a cap of $400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed after that date. Any credits not used in the taxable year may be carried forward up to eight taxable years.

A qualified employer is a taxpayer employing 20 or less employees.

In addition, both the Personal Income Tax Law (PITL)[1] and Corporation Tax Law (CTL)[2] provisions regarding this credit contain certain anti-abuse rules. These rules were designed to prevent an existing business from being treated as first commencing business in the state when the business simply changed structure, i.e. changed from a sole proprietor to an S-corporation.

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[1] CR&TC section 17276.20(f).
[2] CR&TC section 24416.20(g)

THIS PROVISION

For taxable years beginning on or after January 1, 2011, this provision would change existing law to define a qualified employer as one that employs 50 or fewer employees and increase the amount of the credit for each full-time equivalent hired from $3,000 to $4,000.

In addition, this bill would change the cut-off date of the credit to the earlier of when the $400 million cap is reached or December 31, 2012.

IMPLEMENTATION CONSIDERATIONS

This provision has a cut-off date of no later than December 31, 2012. Based on current usage of this credit, the $400 million cap for the credit will not be reached by the December 31, 2012 cut-off date. Additionally, this language would not allow most taxpayers to claim the credit for taxable year 2012. Only those taxpayers that filed their 2012 tax return prior to December 31, 2012, would be eligible for the credit for 2012. That would mean that only entities filing a short period return before the December 31, 2012 cut-off date would qualify. If the author's intention is to not cut off the credit at the end of the 2012 calendar year, then the bill should be amended.

LEGISLATIVE HISTORY

AB 236 (Swanson, 2011/2012) would allow a credit of $5,000 for each full-time employee hired that is either an ex-offender or has been unemployed for 12 consecutive months. This bill was held in the Assembly Revenue and Taxation Committee.

AB 304 (Knight, 2011/2012) would allow a credit of $3,000 or $5,000, dependent on the specified criteria, to an employer with 30 or more employees that moves or establishes a headquarters within California. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 1009 (Wieckowski, 2011/2012) would modify the current jobs tax credit to increase the allowance of the credit from employers with fewer than 20 employees to employers with 100 or fewer employees. This bill was held in the Assembly Rules Committee.

AB 1195 (Allen, et al., 2011/2012) would modify the current jobs tax credit to increase the allowance of the credit from employer with fewer than 20 employees to employers with 50 or fewer employees. This bill is currently in the Senate Appropriations Committee.

SB 640 (Runner, 2011/2012) would allow a credit of $500 per month for each full-time employee hired who has received unemployment benefits for six months prior to being hired. This bill is currently in the Senate Governance and Finance Committee.

AB 340 (Knight, 2009/2010) would have allowed a hiring credit to employers who established a headquarters within California. This bill failed passage out of the Assembly Revenue and Taxation Committee.

ABX3 15 (Stats. 2009, Ch. 10) and SBX3 15 (Stats. 2009, Ch. 17) provided for a tax credit of $3,000 for each net job increase.

SB 508 (Dutton, 2009/2010), SBX6 11 (Dutton, 2009/2010), and SBX8 59 (Dutton, 2009/2010) are identical. These bills would have provided a tax credit for the first $6,000 of wages paid or incurred to an individual documented by the Employment Development Department. SB 508 did not pass out of the Revenue and Taxation Committee; SBX6 11 (Dutton, 2009/2010) did not pass out of the Senate Revenue and Taxation Committee; SBX8 59 did not pass out of the Senate Revenue and Taxation Committee.

SB 612 (Runner, 2009/2010) would have provided a tax credit of $500 per month for each qualified employee employed by a taxpayer. This bill did not pass out of the Senate Revenue and Taxation Committee.

PROGRAM BACKGROUND

As of July 2, 2011, the total Personal Income Tax and Business Entity returns claiming the Jobs tax credit were 10,081, and the amount of credits claimed was $59.5 million. The cut-off date will be the last day of the calendar quarter within which the FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total $400 million.

OTHER STATES' INFORMATION

The states surveyed include *Florida, New York, Illinois, Massachusetts, Michigan, and Minnesota.* These states were selected due to their location and similarities to California's economy, business entity types, and tax laws.

Florida allows businesses located in an Enterprise Zone (EZ) a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas.

New York allows a wage credit to a business that hires a full-time employee (either one in targeted group or not) for a newly created job in an Empire Zone.

Illinois allows a job tax credit for taxpayers conducting a trade or business in an EZ or a High Impact Business. The credit is $500 for each eligible employee hired to work in the zone during the tax year. It is available for eligible employees hired on or after January 1, 1986.

Massachusetts allows a Full Employment credit to employers who participate in the Full Employment Program and continue to employ a participant for at least one full month. The taxpayer may claim a credit of $100 per month of eligible employment per participant, up to $1,200 per participant.

Michigan and *Minnesota* do not offer wage credits.

PROVISION NO. 2: MANDATORY SINGLE SALES FACTOR

Sections 25128, 25136, and 25136.1

Purpose

According to the author's office, this provision would eliminate the competitive disadvantage and level the playing field for California-based companies by eliminating the unfair benefits that companies that moved jobs or based the bulk of their operations outside of California were provided by the change to an annual election with cost of performance for assigning sales.

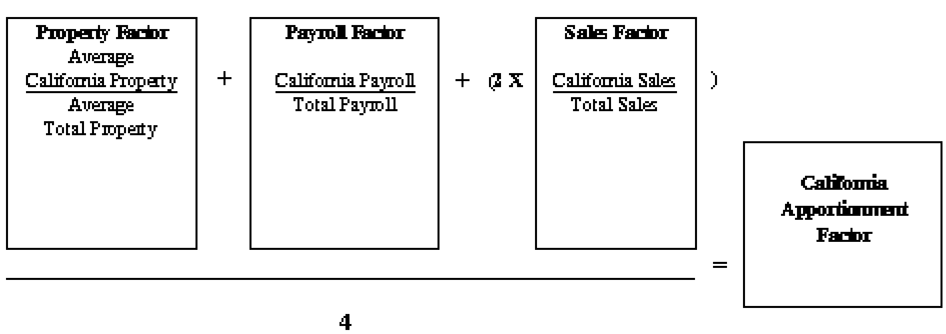
ANALYSIS

STATE LAW

Current state law provides the following general rules to determine the amount of income reportable to California for entities that conduct business both within and outside of California.

Apportionment Formula

State law uses an apportionment formula to determine the amount of "business" income attributable to California.[3] The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction: the numerator is the value of the item in California and the denominator is the value of the item everywhere. The property factor generally includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor generally includes all gross receipts from the sale of tangible property as well as services and intangible property.



[3] "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. R&TC section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales,[4] illustrated above). An exception to this rule exists for taxpayers that are part of an apportioning trade or business that derives more than 50 percent of its gross business receipts from conducting a "qualified business activity."[5] These "qualified business activity" taxpayers are required to use a three-factor, single-weighted sales,[6] apportionment formula (illustrated below).

$$\frac{\boxed{\begin{array}{c}\textbf{Property Factor}\\ \frac{\text{Average California Property}}{\text{Average Total Property}}\end{array}} + \boxed{\begin{array}{c}\textbf{Payroll Factor}\\ \frac{\text{California Payroll}}{\text{Total Payroll}}\end{array}} + \boxed{\begin{array}{c}\textbf{Sales Factor}\\ \frac{\text{California Sales}}{\text{Total Sales}}\end{array}}}{\mathbf{3}} = \boxed{\textbf{California Apportionment Factor}}$$

For taxable years beginning on or after January 1, 2011, an apportioning trade or business (other than an apportioning trade of business that derives more than 50 percent of its gross business receipts from conducting a qualified business activity), is allowed to make an annual, irrevocable election to utilize a single factor, 100 percent sales (single sales factor), apportionment formula instead of the three-factor, double-weighted sales apportionment formula.

$$\frac{\text{California Sales}}{\text{Total Sales}} \quad \text{equals} \quad \text{California apportionment factor}$$

The election must be on a timely-filed original return in the manner and form prescribed by the FTB.

Pre-2011 Rules For Assigning Sales

<u>Sales of Tangible Personal Property before 2011 (Joyce Rule)</u>

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

[4] This formula is sometimes referred to as the "four-factor" formula because of double weighting of the sales and the denominator used is "4."
[5] Extractive, agriculture, savings and loan, and banks and financials.
[6] This formula is sometimes referred to as the "three-factor" formula because the sales are single weighted and the denominator used is "3."

This is commonly called the Joyce rule because the rule was declared in a decision of the Board of Equalization.

Sales of Other Than Tangible Personal Property (Intangibles and Services)

- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state. For example, a taxpayer provides non-personal services to a client in California. The taxpayer incurs direct costs (salaries, equipment costs, etc.) to provide the service in Oregon and California. The total costs are $10,000. The Oregon costs are $4,800 (48%). The California costs are $5,200 (52%). Based on the greater cost of performance, 100 percent of the receipts for the service provided to the California client would be assigned to California.
- Sales from the performance of personal services are assigned to California if the services are performed in California. If personal services are performed in more than one state, the receipts from the services are assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere. For example, a taxpayer provides personal services for a single client in Oregon, Nevada, and California. The total time spent is 1,000 hours for all of the services. The hours are divided between the states as follows: 600 hours in Oregon, 100 hours in Nevada, and 300 hours in California. The total receipts for the services for the client are $20,000. Based on the ratio of time spent, the amount assigned to California is $6,000, which is 30 percent of the total time.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

Post-2010 Rules For Assigning Sales

Sales of Tangible Personal Property (Finnigan Rule)

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the taxpayer's combined reporting group[7] is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state and neither the taxpayer (seller) nor any other member of the combined reporting group is taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

[7] A combined report is a report (a single tax form for the group) in which the business income and apportionment factors of a unitary group of corporations are combined for purposes of determining each taxpayer's share of the California unitary business income. A combined reporting group would be all of the taxpayers included in a single combined report.

This is commonly called the Finnigan rule because the rule was declared in a decision of the Board of Equalization.

Sales of Other Than Tangible Personal Property (Intangibles and Services)

- Sales from services are assigned to California to the extent the purchaser of the service receives the benefit of the service in California. (Market Rule)
- Sales from intangible property are assigned to California to the extent the property is used in California. In the case of marketable securities, sales are assigned to California if the customer is in California. (Market Rule)
- Sales from the sale, lease, rental, or licensing of real property are assigned to California if the real property is located in California.
- Sales from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

Current law blends these two approaches – the market rule and the cost of performance rule – depending on whether an election is made by the apportioning trade or business to utilize the single sales factor apportionment method.

For taxable years beginning on or after January 1, 2011, an apportioning trade or business that does not make the election to use the single sales factor apportionment formula must use the pre-2011 income producing activity/cost of performance rules (see above) to assign all sales other than sales of tangible personal property.

If the single sales factor election is made inoperative by future legislation, all apportioning trades or businesses would be required to use the pre-2011 rules (see above) for assigning all sales other than sales of tangible personal property, commonly called ”cost of performance.”

An apportioning trade or business that has made a single sales factor election must use the post-2010 rules (see above) operative for years beginning on or after January 1, 2011, commonly referred to as the “market rule,” to assign all sales other than sales of tangible personal property, namely sales of intangibles and services.

THIS PROVISION

This provision would do the following:

- Makes the single sales factor apportionment formula mandatory for all apportioning trade or businesses, except those in a qualified business activity (extractive, agricultural, savings and loans, and banks and financials) or those apportioning trade or businesses that make an election to use the four-factor formula. The election is only available if the tax, before credits, using the four-factor formula is not less than the tax, before credits, using the single sales factor apportionment method. This election is available for taxable years beginning on or after January 1, 2011.

- Repeals the elective single sales factor provisions.

- Removes references to the provisions of the repealed elective single sales factor.
- Revises the provision that determines how to assign sales of other than tangible personal property, to require the use of "cost of performance" for assigning sales for taxable years beginning before January 1, 2011, and require all taxpayers, including those businesses in a qualified activity, to use the "market rule" for assigning sales of other than tangible personal property to California for taxable years beginning on or after January 1, 2011.
- Adds a provision to allow qualified taxpayers to exclude 50 percent of the total California sales of the apportioning trade or business determined under the market rule from the numerator of their single sales factor. A qualified taxpayer means:
  - a member of a combined reporting group that is also a qualified group; and
  - a qualified group that satisfies both of the following conditions:
    - has a minimum investment of $250,000,000 in California for the taxable year; and
    - for 2006, derived more than 50 percent of its U.S. network gross business receipts from operations of one or more cable systems.
- Makes non-substantive changes to the order, but not the language, of the subdivision that defines a "qualified business activity."

LEGISLATIVE HISTORY

AB 1935 (DeLeon, 2009/10) would have mandated the use of the single sales formula for all companies except for financial institutions and oil companies, which, as under current law, would continue to use the three-factor formula. This bill was held in the Assembly Appropriations Committee.

SB 858 (Stats. 2010, Ch. 721, Committee on Budget and Fiscal Review), among other things, reinstated the "cost of performance" rules for assigning the sales of intangibles and services for non-electors of the single sales factor formula.

SBX3 15 (Stats. 2009/10 Third Extraordinary Session, Ch. 17, Calderon), allowed specific entities to elect to utilize a sales only formula to apportion its income subject to franchise or income tax and modified the rules for assigning certain receipts for inclusion in the sales factor.

SBX6 18 (Steinberg and Alquist, 2009/10) would have required the use of the single sales factor formula for apportioning income for taxpayers not in a qualified activity. No hearing was held for the bill.

OTHER STATES' INFORMATION

In addition to California, 24 states have implemented or are in the process of phasing-in the single factor apportionment method. Of these, 18 states require use of the single sales factor: Colorado, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New York, Oregon, South Carolina, Texas, Washington, and Wisconsin. Only one state (Missouri) is like California's law, which allows corporations to annually elect which formula they prefer.

PROVISION NO. 3: EDUCATION CONTRIBUTION CREDIT

Sections 17053.86 and 23686

Purpose

According to the author's office, the two new tax credit programs - the K-12 Education Investment Tax Credit and the Higher Education Investment Tax Credit – would provide taxpayers with access to $1 billion in tax credits, and direct funds generated to under-funded public education systems. These tax credit programs will help rebuild the state's investment in education.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Currently, neither federal nor state law provides a credit for contributions to a special education fund.

THIS PROVISION

This provision would allow taxpayers to receive a credit against their "tax" for 75 percent of any cash contributions made to either of two new education funds. If the credit allowed is more than the amount of tax for the current taxable year, the credit can be carried forward to the subsequent six years. The total credits for any calendar year is capped at $1 billion. The credit is allocated on a first-come, first-served basis. The cut-off date for the credit is the last day of the quarter that the FTB estimates it will receive originally-filed tax returns claiming the credits totaling one billion dollars for the calendar year.

TECHNICAL CONSIDERATIONS

The language for the cut-off date is unclear. It appears that the intent was to have the cut-off date be the last day of the quarter that the FTB estimated the credits claimed on timely filed original returns received by the FTB would total $1 billion for the calendar year.

The language currently says that the cut-off date is the last day of the quarter within which the FTB estimates it will receive timely-filed returns claiming credits. The FTB receives timely-filed original returns all year long. Amendments 1 and 2 are provided to correct the cut-off to be the last day of the quarter FTB estimates it would receive credits claimed totaling $1 billion for the calendar year.

LEGISLATIVE HISTORY

AB 1262 (Haynes, 2005/06) would have created a 75 percent credit for donations to a nonprofit organization that provides scholarships to elementary and secondary school students. The bill was held in the Revenue and Taxation Committee.

FISCAL IMPACT (all provisions)

The July 7, 2011 amendments added two new provisions (expand new jobs credit and education contribution credit) to the bill. The education credit provision would require the department to track the credits which would impact the department's printing, processing and storage costs for tax returns. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT- SUMMARY REVENUE TABLE

Estimated Revenue Impact of SB 116 as Amended on 7/7/2011
For Taxable Years Beginning On or After January 1, 2011
Enactment Assumed After June 30, 2011

	2011-12	2012-13	2013-14	2014-15
Job Tax Credit	-$45,000,000	$22,000,000	$45,000,000	$55,000,000
Education credit	-$420,000,000	-$900,000,000	-$950,000,000	-$950,000,000
Mandatory SSF	$1,300,000,000	$1,100,000,000	$1,100,000,000	$1,000,000,000
Special sales rule-cable corps	-$38,000,000	-$38,000,000	-$37,000,000	-$39,000,000
Net Fiscal Impact	**$797,000,000**	**$184,000,000**	**$158,000,000**	**$66,000,000**

SUPPORT/OPPOSITION

Support: Community College League of California, BayBio, BIOCOM, and Qualcomm.

Opposition: CalChamber, CalTax, and California Manufacturer's and Technology Association.

ARGUMENTS

Pro: Supporters would argue that the new jobs credit provision would stimulate job creation by offering a tax incentive to businesses that have the ability to employ new workers and expand their current workforce. The single sales factor provision would make California consistent with the movement by other states to move to a mandatory single sales factor for all apportioning taxpayers doing business in this state. The education credit provision provides needed funding for California's public education system.

Con: Opponents would argue that the new cut-off date of December 31, 2012, unintentionally prevents the revised jobs credit from being fully utilized to create new jobs in California. Opponents of mandatory single sales factor could argue that the mandatory single sales factor adds additional tax burden to out-of-state California taxpayers making California a less desirable place to do business for out-of-state taxpayers. Opponents could argue that the size of the education contribution credit might direct contributions away from other charitable organizations.

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Franchise Tax Board's Proposed Amendments to SB 116 as amended on July 7, 2011

AMENDMENT 1

On page 17, line 16, after "Section 23686" insert:

totaling one billion dollars ($1,000,000,000) for the calendar year.

AMENDMENT 2

On page 27, line 34, after "Section 23686" insert:

totaling one billion dollars ($1,000,000,000) for the calendar year.